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“CONTRACTS IS NOT DEAD”

E. Allan Farnsworth†

Thank you Judge Bork. I am going to save Professor Barnett until rebuttal. I am now going to attack Justice Grodin a little and Mr. Olson a lot, as he has written a book, exposing him on every flank.

I largely agree with Walter Olson on two principles. One is that you should make your own bed and lie in it. And the other is that you should not whine if the other party reallocates. The first says that if you shift risk or limit liability in your contract, you should be stuck with that. The second says that if one party commits what some law and economics folks call an efficient breach, the other party should not whine or ask for punitives, although the aggrieved party is entitled to compensation. By and large I tend to agree with those principles, but I want to make two exceptions.

One exception is for consumer cases. In Mr. Olson's chapter on contracts in his book, *The Litigation Explosion*, he spends most of his time on unconscionability cases involving consumers. To show my mean streak, I want to point out that all of those cases were at least ten years old when the book was published. I have a more upbeat message which I will give shortly. But consumer cases are something we might argue about.

Personal injury cases also pose problems. As to them, I have a sense of *déjà vu*, as this is the room in which the Reporter for Restatement projects in the American Law Institute defends drafts before much less friendly audiences. They tell you what you have done wrong and take votes requiring you to redo your work. One of the things that I had the pleasure of presenting here was a provision in *Restatement (Second) of Contracts* § 195(3): a term exempting the seller of a product from special tort liability for physical harm to a user or a consumer is enforceable if the the term is “fairly bargained for and is consistent with the policy underlying that liability.”¹ If

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¹ RESTATEMENT (SECOND) OF CONTRACTS § 195(3) (1981).

you think that is too cautious a statement of freedom of contract, take a look at comment m to section 402A of the *Restatement (Second) of Torts*, which says that you simply cannot disclaim the liability stated in that section. It took some diplomatic skill to get the American Law Institute to do a flip-flop and say in the black letter something that was the opposite of what they said in the torts comment.

I have limited disagreement with Mr. Olson, but my message is different. His was that contracts is going to the dogs, maybe even dying. Justice Grodin may have reinforced that from another perspective. Judge Bork said that this is what he liked to hear in the morning, a dismal message. Professor Barnett was more upbeat and I intend to be upbeat as well. I do not know whether this will make Judge Bork's day or ruin his morning. I am going to talk about four developments in the last year or so that seem to be encouraging. I am going to be anecdotal, as Mr. Olson was anecdotal. I am sorry to tell you the anecdotes that I will tell are less funny than his—the ones where the bad guy wins after getting hit by the foul ball or the bad gal wins after botching the recipe by putting the can in without opening it. If those people had lost, however, nobody would have talked about the case and certainly if they had, nobody would have laughed.

Now, point one: you make your bed and lie in it. I think unconscionability in the commercial area is overrated as a subject of discussion. There are franchise cases in which a gas station operator with a high school education does battle with an oil company over an allegedly unfair contract. They are not so different from consumer cases. Then there are people who are now stylishly described as persons in agribusiness but who would have been called farmers a few years ago, and who have trouble reading the things on bags of seed and pesticides. And then there are the unfortunate businesses that get their ads botched or omitted in the yellow pages so that nobody calls them. Those are some of the players in commercial cases. There is a bigger game, however. The cases involving limitations of remedies are much more important. That is a field where things have been in equipoise for nearly ten years and it is interesting to see which way courts might be heading.

Manufacturers and other distributors frequently put in a provision saying that all they will do for you if something goes wrong is repair or replace, and that they are also not liable for any consequential damages. Those are two separate provisions. What the courts did first was to use a rather arcane provision of the Uniform Commercial Code that says if a limited remedy fails of its essential purpose, the court can ignore it and apply any remedy that would

otherwise be available.² Courts reasoned that if you say you will repair or replace something, but you do not fix it and it still will not work, then the limited repair or replace remedy fails in its essential purpose. You can reasonably argue with that, but that is the way most courts have gone. What is most surprising is that since about 1977 a series of cases called the "house of cards" cases say that if your repair and replacement provision falls, then everything else falls like a house of cards, including the no consequential clause.³ You are then exposed to full liability. The first case on that was an 8th Circuit case in 1977 called *Soo Line*.⁴ Walter, do not flinch, the word is S-o-o, not S-u-e. Many similar cases have been in the federal courts on diversity jurisdiction and who knows what on earth the state courts would do if they were to decide the cases. In the last year, the Supreme Judicial Court of Massachusetts has come out with a significant decision rejecting the house of cards view and saying that if you put in two distinct provisions and one is stricken under the code, then the other one remains.⁵ You can try to attack the negation of consequential on grounds of unconscionability. But, unless you run a gas station, are buying seed, or are listing yourself in the yellow pages, you probably will not have a great deal of success.

There is another case from a court at least as well-known as the county court that decided the Walter Olsen's *Cubs* case.⁶ It is *Carnival Cruise Lines v. Shute*,⁷ a consumer case decided by the Supreme Court earlier this year with two justices dissenting. The Shutes, who were from the state of Washington, decided that they would take a cruise to Mexico that originated in Los Angeles. They went to a Washington travel agent, bought a ticket, flew to Los Angeles, got on a ship, and went off to the Mexican coast. Mrs. Shute slipped on a deck mat during a tour of the galleys and, figuring that there was tort liability, sued in Washington. Carnival Cruise Line said, "Look on the back in the fairly fine print. It says you have to sue us in Florida; we are a Florida corporation."⁸ The Ninth Circuit had held that this provision was not enforceable.⁹ But the Supreme Court said it was enforceable.¹⁰ This case has an interesting discussion which you ought to look at in comparison with Justice Grodin's dis-

² U.C.C. § 2-719 (1990).

³ See, e.g., *McKenna v. Ortho Pharmaceutical Corp.*, 622 F.2d 657 (3d Cir. 1980).

⁴ *Soo Line R.R. v. Freuhauf Corp.*, 547 F.2d 1365 (8th Cir. 1977).

⁵ *Canal Elec. Co. v. Westinghouse Elec. Corp.*, 548 N.E.2d 182 (Mass. 1990).

⁶ See Stacy Adler, *Chicago Jury Takes Swing at Cubs*, *Bus. Ins.*, Dec. 4, 1989, at 3.

⁷ 111 S. Ct. 1522 (1991).

⁸ *Id.* at 1524.

⁹ *Id.* at 1524-25.

¹⁰ *Id.* at 1526-29.

cussion of adhesion contracts. Note that the Shutes lost a fairly appealing case. They were in Washington. They never had any contact with Florida. The Florida company's ship was operating on the West Coast. They did not go to Florida to take the cruise, but went to Los Angeles to take it to Mexico. Nevertheless, the Court said that the defendant wanted to be sued in Florida, that that is more efficient for the defendant, and that one pays less for a ticket because of that efficiency.¹¹ There is nothing wrong with an adhesion contract, *per se*. The mere fact that it is a standard form in what is today's common method of doing business is not an impediment to enforceability.

The second point is no punitive damages. Although Mr. Olson in his book discussed punitive damages, he did not do so this morning. But other speakers, including Vice President Quayle, have said things at recent meetings about punitive damages. In the early 1980s, when Justice Grodin was a member of the California Supreme Court, the court handed down a unanimous decision, with a separate opinion by Chief Justice Bird, urging the court to go even beyond what they did. It was the *Seaman's Direct Buying Service* case,¹² and it extended the bad faith breach liability of insurers, a liability that had spread from California to many other states, where it had also been limited to insurers. By dictum, *Seaman's* extended this liability to ordinary commercial contracts not involving insurers, at least as long as the parties had a special relationship.¹³ Then many intermediate courts in California went on to discuss what would constitute a special relationship. It was commonly assumed that an employment relationship would be a likely candidate for a special relationship under *Seaman's*.¹⁴ But in 1988, the California Supreme Court decided *Foley v. Interactive Data*.¹⁵ Of the *Seaman's* court, only two members remained. Five new members did some violence to the *Seaman's* case, and a recent intermediate appellate court case characterized *Foley* as a drastic change in the Supreme Court's decision.¹⁶ The winds of change blew in 1988. Before *Foley*, one could confidently suggest that at least two spheres of contract relationships, insurance and long-term employment agreements, could give rise to bad faith breach and tort damages. But after *Foley*, only insurance was left, which suggests that California was back to where they were before the *Seaman's* case. The *Seaman's* case has not been widely followed elsewhere. Montana is a state where bad faith

¹¹ *Id.* at 1527.

¹² *Seaman's Direct Buying Serv. v. Standard Oil Co.*, 686 P.2d 1158 (Cal. 1984).

¹³ *Id.* at 1166.

¹⁴ *Id.* at n.6.

¹⁵ *Foley v. Interactive Data Corp.*, 765 P.2d 373 (Cal. 1988).

¹⁶ *Copesky v. Superior Court*, 280 Cal. Rptr. 338 (Cal. App. 1991).

breach is still alive and well, though no longer a tort.¹⁷ But certainly the experience in California is an upbeat one for those who think that punitive damages have no place in contracts.

I will mention only briefly another development: punitive damages in arbitration. This raises two questions. One is, "Do arbitrators have power to award punitive damages?" The state that has the most negative view on this question is New York, going back to a case called *Garrity v. Lyle Stewart*.¹⁸ *Garrity* says that under New York law arbitrators do not have the power to award punitive damages. The other question is, "Would it make a difference if you were in an arbitration governed by the Federal Arbitration Act?" The Federal Arbitration Act¹⁹ governs international arbitrations and many domestic arbitrations, and I think most people thought that *Garrity* was dead in cases governed by the Federal Arbitration Act because federal arbitration policy would prevail.

In the last year two cases, *Barbier v. Shearson Lehman Hutton, Inc.*²⁰ and *Fahnestock & Co. v. Waltman*,²¹ were decided in the Southern District of New York, expressing opinions in opposite directions. *Barbier* said yes: the federal act governs even though New York substantive law is applicable; the arbitrators can award punitive damages. *Fahnestock* said no: if New York law governs, the Federal Arbitration Act does not preempt and arbitrators cannot award punitive damages. The Second Circuit has recently passed on the *Fahnestock* case²² and has upheld the view that *Garrity* applies even though the arbitration is generally governed by the federal act as long as a New York law is applicable.²³

So my message is: I do not disagree with Mr. Olson on some of the fundamental points, especially as applied to commercial cases, but be of good cheer, contracts is not dead. It is not even going to the dogs, but is alive and well. Some of you will remember that both yesterday and this morning in Judge Bork's introduction, reference was made to the changing role of a changing judiciary. Certainly those of you who look at the *Carnival Cruise Lines* case²⁴ in the

¹⁷ *Story v. City of Bozeman*, 791 P.2d 767 (Mont. 1990).

¹⁸ *Garrity v. Lyle Stuart, Inc.*, 353 N.E.2d 793 (N.Y. 1976).

¹⁹ 9 U.S.C. §§ 1-14, 201-208 (1988).

²⁰ 752 F. Supp. 151 (S.D.N.Y. 1990), *aff'd in part and rev'd in part*, 948 F.2d 117 (2d Cir. 1991).

²¹ 1990 U.S. Dist. Lexis 11024 (S.D.N.Y. 1990).

²² *Fahnestock & Co. v. Waltman*, 935 F.2d 512 (2d Cir.), *cert. denied*, 60 U.S.L.W. 3342 (1991), *distinguished in* *Todd Shipyards v. Cunard Line, Ltd.*, 943 F.2d 1056, 1063 n.6 (9th Cir. 1991) on the ground that in *Todd* "the expansive AAA arbitration provision was a part of the contract."

²³ *Id.* at 518.

²⁴ 111 S. Ct. 1522 (1991).

Supreme Court and look at the *Foley* case²⁵ in the California Supreme Court will have the view that if the courts as they were constituted ten years ago had faced those cases, they would not be examples that I would have given you this morning for the increasing or at least resurgent role of contract as opposed to tort.

²⁵ 765 P.2d 373 (Cal. 1988).